

Documentation Requirements

- Official Statement
- Trust indenture
- State authorizing legislation
- Audited historical revenues for 10 years

responsible for the honest and fair operation of the games.

Financial Operations

To assess a state lottery's financial position, Standard & Poor's analyzes at least 10 years of trends in historical revenue growth with particular attention paid to cyclical fluctuations and overall volatility. Historical pledged revenues that provide higher coverage offer some protection from cyclical factors.

Based on the relative inexpensiveness of lottery games as an entertainment item and the attraction of potential winnings, state lottery receipts nationally have increased over the past 10 years and have been somewhat insulated from recessionary cycles.

Lottery revenue projections depend on a number of underlying demographic and economic factors, including state population, state income, statewide employment, and job growth trends. Although Standard & Poor's considers future projections of lottery revenue growth, it does not use projections as a major basis for determining a rating.

Legal Provisions

Lottery-backed debt typically is secured by a pledge of net revenues after collections and

administrative expenses, as well as certain allocations to the state general fund. Variability in the distribution procedure can be mitigated by statutorily controlling expenses and by establishing allocation formulas or caps.

Lottery-secured debt typically has an open flow of funds, whereby net revenues not needed to pay debt service will revert to the state general revenue fund for other purposes so that the pledge of new or additional lottery revenues will not hamper funding of other state programs.

The lien position of pledged revenues is very important. If there is no formal cap or dedication of revenues, Standard & Poor's will analyze the state's historical financial position and how revenue shortfalls, if any, were met in order to gauge the potential that a state may be compelled in the future to redirect a greater share of lottery revenues for general fund purposes.

The additional bonds test is very important, as it ensures a minimum level of debt service coverage of future maximum annual debt service before additional debt can be incurred. Additional bonds tests should be historical in nature, specifying that revenues must cover future maximum annual debt service on historical and proposed debt by a fixed percentage before new bonds can be issued. All other things being equal, a higher additional bonds test and coverage level usually lead to a higher rating, unless the issuer's lack of adequate revenue collection history or revenue volatility becomes a limiting factor.

Given the discretionary nature and quality of the pledged revenue stream, a debt service reserve fully funded from bond proceeds is a rating factor.

Special-Purpose Districts

Service System Districts

Special purpose service system districts are political subdivisions created to provide economic development or related services to an area—residential, commercial, or industrial—that imposes an ongoing ad valorem tax levy or charge a specific user fee to fund service operations. Special-purpose districts may be located within an incorporated municipality, but most are in unincorporated, developing areas. Special-purpose districts may provide a wide variety of services, but most commonly they provide public utility services such as water, sewers, and drainage. Special-purpose districts also fund hospitals, fire protection, parks, cemeteries, soil conservation, roads, and other services.

Special-purpose service system district debt obligations may carry:

- Revenue pledges of system operations;
- Property tax pledges; or
- A combination of the two.

Special-purpose districts, which are not fully developed, are generally characterized by higher debt and the involvement of a developer or developers, who are trying to activate residential, commercial, or industrial construction. Mature districts may experience little, if any, additional development and typically carry moderate debt burdens. Based on the varying size and complexity of special-purpose districts, management requirements differ. In some cases, a full-time administrator or manager

and staff are responsible for district operations; smaller districts may employ management companies or a part-time administration. Almost all special-purpose districts give ultimate decision-making power to a board of directors that is independently elected or appointed by another governmental entity or entities. However, in some cases, this arrangement may create conflicts of interest if a major taxpayer, such as a developer, is on or effectively controls a board. The special fee or tax that comprises the special-purpose district's revenue source is

often tied to an identifiable service or improvement. For example, a flood control project or sewer hookup would be an effective use of a special-purpose service system district, because the benefit can be tied to a specific group of taxpayers who share in the benefit. When the special-purpose service system district encompasses a new residential development, the fees, charges, or taxes sometimes are capitalized into home costs. The ultimate purchasers of the residential properties will bear these costs. If not capitalized, such payments can be made in a lump sum or over a specific time period, usually 10 years.

The time frame forces Standard & Poor's Ratings Services to focus on the surrounding economy and its vulnerability to swings in the local business and economic cycle. In areas greatly affected by cyclical downturns, significant declines may occur in special district collections. Standard & Poor's has seen cases where collections faltered badly in recessions, returning to more acceptable levels only after district management intensified collection efforts. At the same time, and in the same general area, collections on general property taxes hardly fluctuated from historical norms.

Because of the large development risk in startup situations, or in highly concentrated developments, special considerations apply.

Financial and Operational Data

With respect to financial data, Standard & Poor's prefers to review a historical three-year period plus the current year's budget. Coverage is usually calculated with and without tax revenues to indicate relevance and proportional importance to the entire revenue structure. Balance sheet items are carefully considered for the equity aspect. Planning is the key to management's effectiveness in producing desired goals. Standard & Poor's would like to be apprised of all plans through reports and/or meetings with management. A Standard & Poor's field trip to the site is recommended if credit is to be given for substantial future development. Indices for residential, commercial, and industrial development in the district and area are essential. Where possible, development projections should be supplied for several years, permitting evaluation of future potential and estimated time to future build out. Standard & Poor's tries to obtain an idea how quickly debt burdens may decline as the district develops and what additional debt needs there may be.

Standard & Poor's prefers to review real estate trends from several vantage points: price, volume, and absorption rate. Per-square-foot costs are probably the easiest to compare area-wide. A profile of the potential purchaser is helpful,

Information Requirements

To rate the debt of special-purpose service system districts, Standard & Poor's needs information aside from the standard GO requirements. The following itemized list, although tailored specifically to sewer and water districts, generally covers additional data needed for all special-purpose district ratings:

- A field trip to the district site is recommended.
- A copy of the bond resolution and/or bond ordinance, and all leases and contract agreements with other districts.
- A copy of all applicable statutes concerning organization, powers of the governing board, and debt issuance authority.
- Outside agencies with the power to limit revenue sources or control development should be discussed.
- Legal limits on the district's revenue sources should be explained.
- A description of all insurance carried on the facilities, including general liability insurance.
- A description of management, including the number of board members and the method of election or appointment, and the role of the leading administrative person(s). There should be a description of experience and common interests of board members, staff and leading developers. If the district is operated by a management company, some information about the firm's experience is necessary.
- A certified independent audit for at least one year is required. Up to five years of audits should be supplied when they are available, along with the previous year's accountant's management letter, when it exists relative to the audits. In cases where the special district financial reports do not conform to GAAP, Standard & Poor's will evaluate the reliability of the reports on a case-by-case basis.
- Where there is a budget, it should be supplied.
- Information on local school districts and other overlapping governmental units must be provided, including future debt-issuance plans, and, for school districts, enrollment trends and plant capacity.
- Procedures for the annexation of additional area by the district and for the annexation of the district by incorporated municipalities also are required.
- Details of past new construction by year (at least one year and for five years, if available), amount, and type (residential, commercial, or industrial) are necessary.
- A development plan and engineering report detailing water and sewer trunk lines in existence and planned, the amount of land developed and the amount remaining suitable for development, and a summary of the type of contributions required of developers are needed. The latter would include roads, lateral sewer and water lines, and, in some rare cases, direct contributions to school construction. The adequacy of trunk lines for additional planned hookups and the expected life of the lines also should be treated.

especially in the residential sector. In certain instances, a developer may be required to make an up-front contribution to a project. The sale of special district bonds is often an aid in financing the developer's obligation. Offering the lower municipal rate is key to the financing agreement. The district's acceptance of a note from the developer can be recognized only if the legal covenants are fairly strong, with a bank line or an LOC backing.

Fee and Tax Structures

Two items essential to debt retirement are fee and tax structure. They should permit capturing of fees and taxes sufficient to satisfy operating and capital needs. Taxes will be considered along with the regular property-tax burden on other debt outstanding. Fees will be considered as to the reliability of their collection and their adequacy in covering all unprovided needs from special district taxes. A dependence on developer fees, which may be of a

one-time nature, to meet debt service can be a negative credit factor.

The emphasis on timeliness of payment is important. A debt service reserve fund is helpful in covering risk. Fundamental considerations of economic strength and the success of the tax structure are critical. How often fees and taxes can be adjusted, and how quickly, is also important. In many cases, the special-purpose district is limited to a certain millage rate, a certain annual increase, or a combination of both. This limit could have profound implications if ad valorem growth declines from previous levels or a major developer-taxpayer files for bankruptcy protection. Relative affordability remains key in this area. Experience proves that the project as a whole must be financially feasible to potential purchasers in the area.

Standard & Poor's views permanent residential communities more favorably than seasonal ones. People who reside in an area year-round are more attentive to tax bills and are more likely to pay on time. For many reasons, seasonal vacation-home owners may not as prompt with tax payments, special fees, and charges. Mixed communities fare better where there is a substantial full-time population. Usually, a minimum of around 500 full-time residents is important to qualify a residential district for an investment-grade rating on special service system district bonds, although peak seasonal populations are examined carefully. If a district is in a portion of an existing city, it would be viewed more favorably than a new area in an unincorporated area. The latter disadvantage can be mitigated by proximity to employment and recreational opportunities. With good statistics to support the argument, a strong case can be made that a district is part of, and not separate from, the prospects of the surrounding area.

Primarily commercial districts may also obtain favorable ratings, assuming reasonable taxpayer diversity and moderate debt burdens, although commercial assessed valuations are generally more cyclical than residential ones.

The individual developer's ability to point to successfully completed projects is a plus in any special district consideration. A developer should be willing to supply some documented confirmation of its ability to bring a project on line and within budget. Also helpful are descriptions of a developer's financings, and a history of mortgage payments. In general, the more information presented substantiating the strength of the district, the less room there is for speculation and uncertainty about the focus and growth of the district in the future.

Common Service System District Characteristics

- Double-barreled security (taxes/water-sewer revenues).
- Higher-than-average debt ratios per capita and to market value.
- High level of debt service to budget (frequently exceeding 20%).
- Debt issues in anticipation of future growth, rather than in response to development.
- Longer average debt maturity.
- Frequently supported by debt service reserve funds.

Administration

- Established with small constituency.
- Revenue stream dependent on demand for, and supply of, services or commodity (sewer/water).
- Short-lived operating track records (many start-up situations).
- Administration and management are frequently minimally staffed and inexperienced or contracted to outside parties.
- Rate setting and budget adjustment may not be timely.
- Single-purpose nature of the district may make the issuer more prone to bankruptcy filing.
- Subject to annexation.

Economic

- Frequently rural, or developing suburban.
- Rapid growth characteristics.
- Debt usually issued primarily in early stages of development.
- Major taxpayers often dominated by developers and speculators.
- Small size, frequently accompanied by lack of diversification.

Financial

- Tax collections and service charges subject to volatility.
- Little or no operating history.
- Accounting and financial reporting variations (hybrid of government enterprise accounting).
- Increased importance of financial and capital planning and feasibility studies.

Tax Increment Bonds

Tax increment financing, sometimes called tax allocation bonds, have been issued in a majority of states, although California redevelopment agencies continue to account for the bulk of national volume. Tax increment financing attempts to repay debt solely from taxes generated from the increase in property value in a district after a redevelopment project has begun. As such, it does not raise the tax rate on district taxpayers, but merely reallocates tax revenues that would otherwise flow to pre-existing taxing entities in favor of a redevelopment agency that issues debt. Tax revenues from pre-existing property before the tax increment district was formed continue to flow through to the underlying taxing entities as before; only the taxes attributable to the increase in property values flow to the redevelopment agency and are pledged to bondholders.

Tax increment bonds benefit from several favorable structural elements compared to other special district debt. Unlike special assessment and Mello-Roos bonds, no additional tax burden is created for taxpayers, and tax collection rates are generally less of a concern, unless project area tax payments are concentrated in a few taxpayers. In addition, while undeveloped land in a special assessment or Mello-Roos district creates high debt burdens, undeveloped land in a tax increment district is generally a favorable factor, since revenues will increase to the

extent new development occurs and taxable property values grow. In contrast, revenues do not grow for special assessment or Mello-Roos debt because those taxes are not based on land value, although development may lead to more favorable value to debt ratios for those types of districts.

The main credit risk for tax increment districts is that tax rates and the pace of private development in a project area lie outside the control of the redevelopment agency issuing the debt. Actual tax rates generating the tax are set by the underlying taxing entities—cities, counties, school, park districts, and others—that set their tax rates without consideration of the needs of the redevelopment agency. Changes in state tax law, or assessment practices, can dramatically influence tax increment revenue.

A typical investment-grade tax increment district already generates sufficient revenues to cover future maximum annual debt service at the time of the sale of bonds, a feature sometimes called “coverage in the ground”. However, the experience of southern California during the 1990s shows that many different factors can subsequently reduce tax increment revenues. Some of the common pitfalls of these bonds include volatility in commercial real estate values during an economic downturn, particularly for warehouses and hotel properties, widespread tax appeals that can overwhelm county assessment offices, a residen-

Tax Increment Bond Volatility Ratio

The mathematical formula used to compute incremental tax revenues does not treat all project areas equally on a general decline in assessed values. Tax increment project areas containing a small amount of incremental valuation in relation to their total assessed value will show greater volatility revenues. This is often the case for recently formed project areas. Thus, two project areas, with the same amount of total assessed value, can have unequal loss of tax increment revenues, even when losing the same amount of total assessed value.

Standard & Poor's uses a revenue volatility ratio to highlight the speed at which revenues can fall in the event assessed values decline. The ratio consists of the project area's base assessment to total assessment. This ratio can serve as a proxy for the speed with which tax increment revenues will rise or fall in the event of a fluctuation in assessed value. Standard & Poor's expresses the volatility ratio of base assessment to total assessment as a decimal fraction between 1.0 and 0.0. A higher number represents more volatility. In other words, revenues will rise or fall more rapidly with a small change in project area assessed valuation when the ratio is high. The ratio is incorporated as part of Standard & Poor's rating process.

The ratio serves as a convenient flag for the most vulnerable districts in times of real estate decline. Most of the tax allocation bonds that experienced troubles during California's real estate downturn of the 1990s had high volatility ratios.

On the other hand, a high volatility ratio can also cause a quick increase in revenues and coverage in the event of even modest assessed value increases.

In the example, project areas A and B have the same assessed value and tax allocation coverage, but would respond very differently to a 10% decline in overall project area AV. Project area A has a low base-to-total assessed value volatility ratio of 0.2, while Project area B displays higher revenue volatility with a change in assessed valuation, with a volatility ratio of 0.8. Project area A, which is older and has a smaller base valuation, suffers a much smaller decline in coverage, from 2.0x to 1.75x if total assessed valuation declined 10%. Project area B's debt service coverage falls from 2.0x to 1.0x with the same percentage decline in assessed value because it was more recently formed and has a high base valuation relative to total assessed valuation.

The volatility ratio is specific to each project area, and is independent of the amount of debt issued by a project area.

One alternative way to look at this volatility ratio is to examine its inverse. The inverse represents the percentage that total project area assessed valuation must fall to produce zero tax increment revenues. Thus, a high volatility ratio of 0.8 means total assessed value would have to fall 20% before there would be no more tax increment revenues.

tial real estate bust, construction risk on projected projects, state tax law changes, plant closures, concentration in a few taxpayers, purchase or foreclosure of land by tax exempt entities, and a high tax increment volatility ratio for recently formed project areas.

Background

The mechanics of capturing assessed valuation growth are straightforward. The redevelopment agency delineates a project area and declares a base year. The existing base assessed valuation is taxed as before by each overlapping taxing entity covering a portion of the project area. Overall tax rates may vary within the project area, depending on the boundaries of the underlying tax entities, and the sum of their tax rates. Additional assessed valuation added to the tax rolls in future years is taxed at the same tax rate as the base valuation. However, the tax revenue attributable to the new incremental assessed valuation is remitted to the redevelopment agency and pledged to pay debt service. Sometimes a state may reimburse an agency for revenues lost as a result of property tax exemptions. The redevelopment agency has no taxing power and depends on the tax rates set by independent agencies and by private construction activity for its revenues. (In California, current state law mandates a minimum 1% tax rate). A redevelopment agency can increase pledged revenues only by encouraging growth through its redevelopment activities. Nevertheless, new development does not guarantee high revenues, because adverse tax rate changes or subsequent restrictive legislation could affect revenues.

Project area analysis

Standard & Poor's analysis focuses first on general economic factors that may affect the economic growth of the project area, such as a municipality's population, employment, and income level. Building permits may indicate overall city construction trends. Nonetheless, the general character of a city is not necessarily a barometer of the conditions within a localized project area. In this respect, a site visit may help give credence to rapidly improving economic conditions that are not reflected in assessed valuation numbers. One way to get a description of a new project area is to read the redevelopment agency's plan, which outlines prior economic conditions and project objectives.

Taxpayer concentration

One weakness of many project areas is their small size, leading to taxpayer concentration. Standard & Poor's has no size limit on investment-grade rated project areas. Generally, small-

er districts will have weaker credit characteristics and, thus, lower ratings. A larger project area, generally one of over 150 acres, is usually more diverse and more creditworthy. Standard & Poor's analyzes taxpayer concentration by comparing assessed valuation of the top taxpayers to project area incremental value—not project area total value—because revenues rise or fall based on incremental valuation. It is not uncommon to see each of the top five taxpayers accounting for more than 100% of project area incremental valuation in newly formed project areas, even though top taxpayers may appear deceptively diverse when compared to total project area assessed valuation.

Generally, Standard & Poor's requests the assessed valuations of the top 10 taxpayers. It is typical for 40% or more of the incremental tax base to be held by the top five taxpayers, based on the relatively small size of most project areas. Taxpayers may also not appear overly concentrated when considered individually, yet they may still comprise just one shopping mall or condominium development. Market factors can swing the value of such shops and homes together as a result of their common location and function, apart from fire or natural hazard risks of adjacent buildings. Districts concentrated in a particular type of property, such as aircraft capable of moving to other locations, may have other vulnerabilities too, even if they are diverse by taxpayer. If payment of debt service is wholly dependent on just a few taxpayers making their tax payments, it may be difficult to achieve an investment-grade rating unless those taxpayers are themselves rated. Even in the case of a rated taxpayer, however, the property should be highly essential to the taxpayer to get the benefit of the credit rating assigned to the taxpayer. An example would be an important generating plant of a rated investor owned utility.

Assessment practices that may at first appear to "guarantee" tax collections have been shown through experience to not always be reliable. A financially strong company can still remit smaller-than-expected tax payments by appealing its assessment (which can take three years or longer to resolve), not rebuilding after a fire, or delaying initial construction. Taxpayer bankruptcy proceedings can also forestall legal foreclosure or tax assessment sales, since federal bankruptcy law supercedes local law.

Historical assessed valuation growth

Standard & Poor's prefers to examine at least four years of project area assessed values. One of the virtues of tax allocation bonds is the typically high

growth rate of assessed valuation within most new project areas. However, a recent base year may cause deceptive percentage rises in incremental assessed valuation because of the comparison to small early-year incremental values (*see accompanying chart on the tax volatility ratio*). Total project area assessed valuation may be a more meaningful indicator of growth trends. In a few states, fire, demolition, or conversion to tax-exempt property may be used to decrease the frozen base assessment—increasing incremental assessed value—without new construction.

Future assessment growth

An important indicator of future assessment growth is the acreage available for new development. A fully developed area, with no redevelopment potential, effectively limits the possibility of assessed valuation growth. However, project areas with large undeveloped land areas are not assured of attaining growth. Construction strikes, changes in market conditions, or higher interest rates can suddenly cancel or delay even the most promising development.

Construction risk, when present, is such a risk factor that most investment grade-rated tax allocation bonds already demonstrate coverage of maximum annual debt service by historical tax revenues (Standard & Poor's will consider next year's tax levy an "historical" revenue if it is based on the current assessor's assessment roll and the current tax levy), although exceptions have been made when debt service could be covered with only limited amount of future growth that seems especially likely. Historical coverage of debt service alone, however, does not necessarily guarantee an investment-grade rating.

Management

Policy control of a redevelopment agency usually lies in a city council, with an executive director responsible for implementation. The agency holds broad authority to acquire, develop, and administer property, as well as eminent domain powers. Often a major portion of tax allocation bond proceeds is used to acquire and consolidate parcels of land. Questions for management may encompass additional debt plans, unusual features of the redevelopment plan, and the land use breakdown when the plan is completed.

Legal considerations

Standard & Poor's analysis of the legal structure of a tax allocation bond focuses on the security pledge, flow of funds, debt service reserve fund, and provisions governing the issuance of additional parity debt. The flow of funds is usually simple. Tax increment pays debt service, makes up debt

service reserve deficiencies, and then revenues are released for any purpose. Lack of a fully funded reserve is viewed as a negative rating factor in view of the low debt service coverage of most tax increment bonds.

Additional debt issuance is likely over the life of a bond issue. Tests for additional bonds requiring 1.25x coverage of maximum annual debt service by historical revenues, or revenues to be realized as a result of the most recent finalized assessment rolls, are considered a typical provision. However, stricter additional bonds tests may enhance credit quality. Provisions allowing adjustments to revenues based on construction in progress or a consultant's projection can severely weaken the additional bonds test. The coverage multiple required under the additional bonds test is examined in relation to the number of taxpayers excess cash flow could cover in the event of delinquencies among major taxpayers, assuming a redevelopment agency bonded out to the limit of its additional bonds test. Thus, no one additional bonds test or coverage level can guarantee a specific rating.

More established diverse districts have issued debt with less than a 1.25x additional bonds test without a negative impact on their credit rating as their tax volatility ratio declined and their taxpayer concentration diminished. Standard & Poor's weighs a more permissive test against taxpayer diversity, historical and projected growth trends in assessed valuation, the nature of such growth, and the need and likelihood for additional debt issuance. On the other hand, higher debt service coverage and stronger additional bonds tests may offset weaknesses in district economic diversity.

Aside from an issue's legal structure, Standard & Poor's evaluates tax increment authorization laws and litigation. Standard & Poor's examines all new state authorizing legislation for potential problems. Litigation frequently accompanies tax allocation issues, especially in states newly authorizing such financing, because public entities losing the tax revenues have an incentive to sue. Taxpayers and overlapping units often contest the constitutional validity of new tax allocation legislation; counties may wish to postpone the loss of revenues, and taxpayers may want to delay eminent domain proceedings.

Some tax increment bonds also have a pledge of a city's GO. Standard & Poor's will rate such double-barreled securities based on the higher of the GO or tax increment rating, since both are pledged to debt repayment.

Financial operations

Primarily, financial factors include an analysis of fluctuating tax rates, delinquent collection rates (for

the project area, not the city), and historical debt service coverage. No specified level of coverage leads to a particular rating, since taxpayer concentration or legal factors may be much more important. When a particular weakness is identified, it is useful to check coverage sensitivity to such vulnerabilities. For example, if an issuer experiences poor property tax collection, coverage levels and additional bonds tests can be raised to compensate. The lower of the additional bonds test coverage level, or current revenue coverage of maximum annual debt service, is used for analysis. Projected coverage based on construction growth is not always reliable, but worth considering.

Various mathematical considerations concerning the ratio of base to total assessed valuation also may affect the volatility of the revenue stream in the event assessed valuation declines (*see chart on the tax volatility ratio*). In general, the smaller a district's base valuation is compared to its total valuation, the lower the revenue volatility.

Cumulative tax limits

Project areas in California are subject to a cumulative cap on tax increment that can be collected from a project area over the life of the project area. Sometimes, higher-than-projected tax increment can cause the cap to be reached before final bond maturity. If this appears to be a significant possibility, Standard & Poor's would prefer a covenant by the redevelopment agency to annually review the total amount of tax revenues remaining and to escrow revenues or not accept tax monies if it would cause the tax limit to expire before final bond maturity.

Special Assessment Bonds

Special assessment bonds are secured by a special tax, such as a street front-footage assessment, which is levied in relation to the benefit a property receives from an improvement. As a consequence, the tax is not based on the actual value of a property and debt burdens, as a percent of the market value of a parcel, can vary greatly from one parcel to another. Since each taxpayers' tax payments are usually fixed and can not be raised to cover the delinquency of any other taxpayer, credit analysis must focus on the exposure to the weakest properties, even if overall average property value to debt ratios are strong districtwide.

In particular, special assessments on undeveloped land may create burdensome tax payments for those properties. Undeveloped land typically carries property value-to-debt ratios of 3:1 or less, while developed properties are generally closer to 20:1. Standard & Poor's expects investment grade special assessment bonds to be able to at least withstand two separate sensitivity analy-

ses: (1) a permanent tax delinquency by the two largest special assessment taxpayers; and (2) a permanent delinquency by all special assessment taxpayers with under a 5:1 value-to-overlapping debt ratio.

Sources of money to cover potential delinquencies may come from reserve funds, an ability to raise taxes to a limited degree, over-collateralization of tax payments, back-up support from a city's general fund (often found in Arizona), cross-collateralization with other special districts, a senior /subordinate bond structure, or other revenue sources.

Special assessment bonds have proven very popular in growing areas such as California and Florida, where existing residents may be reluctant to pay for infrastructure improvements in new housing developments. However, special assessment financing is used throughout many areas of the country. Examples of projects funded by special assessment bonds include water and sewer lines, lighting improvements, roadways, and sidewalks.

Financing special assessment projects

The special assessment process is often quite simple. In most cases, property owners in a limited area, or their local representatives, petition for the creation of a special assessment district. A project is specified that will directly benefit property owners within the district and be paid for by fees or assessments based on a measurement related to the benefit, such as street frontage or square footage owned. Bonds are sold to finance the project(s), and security is provided by the assessments.

Most improvements provided by special assessment bond financing are related to local infrastructure, although bonds have been sold to finance parking lots, landscaping, and public parks. These improvements benefit district property owners by improving the quality of their neighborhood and contributing to greater property values.

Usually, bonds are used only for the construction of the project and not for maintenance. Often, the municipality will absorb the maintenance cost, since the project generally is tied into a citywide system, such as water and sewer services.

Standard & Poor's believes that the lack of excess cash flow coverage typical for most special assessment bonds may create risks, particularly for undeveloped districts. However, potentially speculative elements can be mitigated through such factors as:

- An ability to raise assessment tax rates to a limited degree;
- The existence of excess cash flow from reserve earnings, refunding savings, or a senior subordinate cash flow structure;

- Strong taxpayer diversity, and a debt service reserve that can cover simultaneous delinquencies of at least the top two taxpayers;
- Particularly strong value-to-lien ratios;
- A lien on parity with or ahead of ad valorem taxes;
- Legal protections within the bond structure;
- Economic incentives for timely payment of special assessment obligations; and
- Low risk associated with the particular project.

Major criteria considerations

Following are some major criteria considerations for special assessment bonds. However, undeveloped districts carry additional development risk.

Project essentiality. The project's degree of importance to assessment payers is an influential factor in determining whether those benefiting from the project will pay their assessment.

Project completion risk. Generally, projects using a known technology and developed by experienced personnel mitigate Standard & Poor's concerns.

District makeup and economic base. A district largely undeveloped or concentrated in one type of industry or assessment base is viewed negatively. A special assessment district tied to a stable and diversified economic base is desirable. The effects of employment levels, wealth indicators, and regional trends on payment of assessments are evaluated.

Assessment basis. The basis for establishing assessments should be objective and equitable.

Method of assessment collection. Special assessments collected at the same time and with the same foreclosure methods of ad valorem taxes is preferred. Standard & Poor's also may regard incentives for early payment and disincentives for late payment as positive features. For example, penalties for late payment and discounts for early payment may be worthwhile, depending on their effect on cash flows.

Value-to-debt ratios. High property value-to-debt ratios, preferably above 7:1 for investment-grade ratings, increase the likelihood of making assessment payments on a timely basis. Also, the marketability of property in the district points to added security if properties must be sold as a result of foreclosure or bankruptcy. Value to lien ratios must be examined on a parcel-by-parcel basis for top taxpayers, since tax levies cannot typically be raised on the strong taxpayers to pay for the weak, rendering overall district value to lien ratios problematical in many cases. Standard & Poor's prefers value to lien ratios using county or city assessed valuation, although independent appraisal reports may be evaluated also if deemed reasonable.

Lien position. A lien on parity with or ahead of ad valorem taxes is desirable. Preferably, the general property tax bill should be combined on the same statement as the special assessment tax bill to help collection rates.

Treatment of property sales. Liens should remain in place upon transfer of property or be extinguished by an immediate acceleration of all outstanding, current, and future special assessments on the property.

Foreclosure/bankruptcy provisions. Assessment collections should not be hindered by foreclosure, bankruptcy, or sales of tax certificates or tax deeds. Action should be taken on a timely basis to ensure that sufficient funds are available to make scheduled debt service payments. The marketability of property is also a concern here; property should have sufficient value that bids will appear for foreclosed property. Requirements allowing and requiring foreclosures to proceed on an accelerated basis compared to that for general property taxes is considered favorable.

Clear right to issue. Public hearings and a deadline for discussion are necessary, within legal requirements, so that there are no legal challenges possible once bonds are offered.

Term and redemption of bonds. The debt service schedule is usually flat or declining over time and should be within the useful life of the project and improvements. Most special assessment bonds have maturities of 15 years or less.

Debt service reserve. A reserve fund or other security feature that provides for payment of debt service is essential in the event that assessments are not received on a timely basis. The amount of the debt service reserve and the way that it is funded are important, because funds to cover any revenue shortfall are expected to be available at all times. Additionally, debt service reserve investments should be in securities with a high degree of safety and liquidity.

Cash flow runs. Sensitivity tests that demonstrate the bond structure's strength in the event of taxpayer nonpayment, prepayment, and anticipated payment are necessary in evaluating the ability of the bond structure to withstand unexpected events. Assumptions regarding interest rates on the bonds and debt service reserve investments should be tested as well. Standard & Poor's normally expects some excess cash, either in a debt service reserve or through excess cash flow, be available to cover a default by at least the top two taxpayers, unless the top taxpayer has itself been rated by Standard & Poor's. In some cases, Standard & Poor's commercial mortgage group can evaluate the credit quality of an individual development for assessment bond purposes and

the rating can be based on a single taxpayer or retail development. Usually, however, Standard & Poor's requests information determining the maximum number of taxpayer delinquencies a district can handle before defaulting and compares this to the concentration of the top taxpayers. Where extremely high taxpayer diversity exists, such as in fully developed residential districts, the debt service reserve alone may be able to cover the permanent loss of the top five taxpayers, mitigating excess cash flow needs.

California's Mello-Roos Districts

Mello-Roos bonds, also known as Community Facilities District bonds, are specific to California. They are similar to special assessment bonds in that they levy a charge that is not based on property value, but dissimilar in that they usually have the ability to raise the tax rate up to a maximum level to cover taxpayer delinquencies. Most Mello-Roos districts levy a tax per dwelling unit or per acre, based on development status, but there is no real restriction on the type of tax other than it cannot be based on property value.

The different types of taxes allowed under the Mello-Roos Act raise varying credit quality considerations, but certain key concerns are common to all Mello-Roos bonds. Probably the greatest credit risks occur in the district's initial phases, when the taxpayer base is concentrated and debt-to-assessed value (loan-to-value) ratios are high because land may be owned by a few developers and largely undeveloped (*see Undeveloped Special Districts*). As development occurs, credit quality should improve to the extent that ownership becomes more diverse, and loan-to-value ratios decrease. Upon a refunding, several years after a district's creation, credit quality could be vastly improved. Even relatively undeveloped land could receive a favorable initial rating if the area is characterized by numerous taxpayers, good loan-to-value ratios, and flexibility to cover taxpayer defaults by raising tax rates.

Generally, investment grade Mello-Roos districts will show at least 1.0x cash flow coverage of debt service from parcels within the district that have an assessed valuation to debt ratio of at least 5:1, with no major taxpayer concentration among these higher value to lien taxpayers.

Easy to implement

Mello-Roos financing is attractive for two reasons. First, unlike special assessment bonds, it allows the financing of general-purpose projects, such as police stations, which may be outside Mello-Roos district boundaries. However, all projects by law must have a useful life of more than five years or

provide additional services previously unavailable. A second attraction is Mello-Roos districts' easy implementation in growing areas because of the enabling act's usage of ambiguities in the California constitution. The state constitution's voter approval requirement for new debt refers to "qualified" voters without specifying who is "qualified" when no voters reside in a district. The Mello-Roos Act declares district landowners to be the voters when 12 or fewer voters reside in a Mello-Roos district, an interpretation that could be subject to future legal challenge if there are actual residents present.

Because districts may be formed in any size or shape, even from noncontiguous parcels, it is relatively easy to form and obtain 'voter' approval of a Mello-Roos district in undeveloped or industrial areas. Different governments, such as school districts or cities, may form separate overlapping Mello-Roos districts as long as each governmental entity is authorized to perform the different service being provided. Practically speaking, district boundaries can be drawn to guarantee that fewer than 12 voters reside in a district or that residents support district formation.

Any type of tax may be imposed in a Mello-Roos district, as long as the tax burden can be evaluated at the time of voter approval and is not levied against property values. In addition, legislation requires maximum potential taxes imposed for bonds sold since 1993 to provide no more than 1.10x annual coverage of bond debt service at the maximum permitted tax rate, although actual coverage may later increase beyond 1.10x if a district's tax formula increases tax rates upon a change in land use, such as might happen in a typical tax formula when a building permit is issued.

Taxes can be designed to mimic property taxes closely, even though by law they can't be imposed solely on the value of a property. For example, a district could tax the number of homes, street frontage, or number of acres. Even a per capita tax can be imposed, using taxes that are fixed or fluctuate up to a cap. To date, an acreage tax or an equivalent dwelling unit tax seem to be the most popular form of taxation. Taxes may kick in on different dates, and maximum permitted tax rates often escalate 2% per year to accommodate an increasing debt service schedule. Generally, undeveloped land (usually owned by developers) is not taxed, or taxed very little, while future homeowners support actual debt service. As long as bonds are outstanding, the tax cannot be repealed.

The many possible Mello-Roos tax structures create different risks depending on their structure.

However, all districts have some features in common. The strongest districts have economic diversity, with numerous taxpayers and high value-to-loan ratios, and levy a well-designed tax that covers a broad tax base. Such a district could receive a favorable credit rating if the existing tax base can produce favorable coverage of future maximum annual debt service, and an additional bonds test locks in the coverage.

The best additional bonds tests use the maximum permitted tax rate on the existing tax base to calculate a minimum coverage requirement on future maximum annual debt service. Weak additional bonds tests may require only an appraiser's report, subject to possible error, estimating a certain minimum value-to-lien ratio. Additional bonds tests based on building permits granted, while stronger than a wholly projected test, are weaker than tests based solely on revenues from owner occupied homes as determined by a certificate of occupancy or the county assessor, due to the time lag between receiving a permit and actually completing a structure.

Concentration of district taxpayers is a particular risk for small or start-up districts. If payment of debt service depends on payments from a few taxpayers, there are obvious vulnerabilities. Apart from the normal cash flow problems caused by delinquency of a major taxpayer, a federal bankruptcy law filing by a taxpayer can indefinitely forestall local foreclosure action. Taxpayer concentration is particularly important, because most districts were originally formed by a few developers holding undeveloped land. The ability to raise tax rates may mitigate concentration risk if additional levies could cover delinquencies by major taxpayers. Sometimes maximum tax rates are

designed to increase a certain percent every year to match an increasing debt service schedule. If so, inflation assumptions should be carefully scrutinized in such a case to ensure that homeowners would not be subject to possibly onerous taxes in later years

Many types of taxes can be imposed and pledged to debt service; therefore, Standard & Poor's will examine each Mello-Roos bond issue on a case-by-case basis. Major rating considerations include:

- Surrounding economic characteristics;
- The nature of the development and the developer's track record;
- Tax-to-property value relationships, with emphasis on the percentage of the tax generated by parcels with value to lien ratios above 5:1;
- Restrictions on additional parity debt;
- Existence of overlapping districts;
- Project feasibility;
- Nature and diversity of items taxed and the tax structure;
- Cash flow timing and sensitivity to taxpayer defaults;
- County assessment and collection practices; and
- The property value added by the funded project.

Certain types of development are subject to more risks than others. For example, multifamily housing projects are more cyclical in their sales patterns than single-family homes, and preleasing may mitigate office building construction risk.

In general, the nature of development risk may introduce varying degrees of speculative characteristics to undeveloped districts owned by just a few developers. However, credit quality may improve rapidly as development occurs, and homes or commercial development are sold off. The ability to

Examples of Different Base to Total Project Area Assessed Valuations

Different volatility with same initial coverage and assessed valuation

| | Low volatility Project area A | High volatility Project area B |
|---|----------------------------------|-----------------------------------|
| Total assessed value | \$500 million | \$500 million |
| Base increment | \$100 million | \$400 million |
| Incremental assessed value | \$400 million | \$100 million |
| Tax rate | 1.00% | 1.00% |
| Pledged revenues | \$4 million | \$1 million |
| Maximum annual debt service | \$2 million | \$500,000 |
| Coverage | 2.0x | 2.0x |
| <i>If project assessed value fell 10%</i> | | |
| Project assessed valuation | \$450 million | \$450 million |
| Incremental assessed value | \$350 million | \$50 million |
| Pledged revenues | \$3.5 million | \$500,000 |
| Coverage | 1.75x | 1.00x |
| Base assessed value to total value volatility ratio | 0.2 | 0.8 |

raise tax rates, while limited by reform legislation, still provides Mello-Roos districts with potentially better credit quality characteristics than most special assessment districts, with which they share many similarities. A number of formerly speculative "raw land" districts now have developed to the point where their credit quality is quite favorable. However, investors still need to do their homework to make sure that structural factors, such as the additional bonds test, and fundamental

economic factors would support a high rating as a district develops.

Undeveloped Special Districts

Standard & Poor's has extended its criteria for special districts, Mello-Roos (Community Facility District), and special assessment districts to include noninvestment-grade debt and more clearly delineate the types of development risk involved in largely undeveloped special districts.

Ranking Characteristics of Special Tax Districts

District is close to fully developed (80% or better); Diverse taxpayer base; Strong economic location; Good coverage of maximum annual debt service; Fully funded reserve; Strong legal protections regarding additional debt issuance, and prompt property foreclosures.

Mostly developed (around 70%); Some taxpayer diversity; Good prospects for economic growth; Only adequate coverage of maximum annual debt service (1.10x), or a weaker additional bonds tests; Fully funded reserve.

OR

District is fully developed (100% built-out); Concentrated tax base (40% of taxes paid by the top five taxpayers); Legal provisions prohibit additional debt issuance unless the maximum permissible tax rate can provide at least 1.20x coverage of future maximum annual debt service. (High concentration can be offset by high coverage); Good economic location.

OR

Only partly developed; Strong economic location; High land values (10:1 assessed value to lien ratio and up); Very diverse taxpayer ownership (top taxpayer is no more than 4% of total taxes); Very strong legal protections regarding additional debt dilution; Good coverage of maximum annual debt service (1.20x +); Mandated quick action on property foreclosures; and fully funded debt service reserve.

Vacant district upon which construction has just begun (land is graded or very partially developed); Appraised market value to lien ratio, using conservative assumptions, ranges from 7:1 to 3:1 or better; Highway access to nearby employment center; Good residential density in surrounding neighborhoods; Strong track record for the developers; Some legal covenant protection on additional debt issuance or coverage margins; a few developers may own the majority of the district during construction.

OR

A major diverse ownership shopping center is planned with pre-leasing in place; Good surrounding residential density; Good legal covenant protection; No major competition nearby; Appraised value to lien of 3:1 or better.

OR

Strong multifamily development under way in a very densely populated neighborhood; Good legal covenant protection; Appraised value of 3:1 or better.

OR

Very small residential district, but already built-out and sold to individual homeowners (only 30 homes, already built); Good legal covenant protection.

Completely undeveloped district with one or two developers as owners; planned for single-family development in a more remote location; 3:1 value to lien ratio; Half-funded debt service reserve.

OR

District is primarily an office building(s) already built without a tenant; Good value to lien ratio; More remote location or lower population density.

OR

Weaker multifamily development already under construction in a more remote location or lower population density neighborhood. Proposed commercial construction with prospects for a glut of competing properties.

OR

Proposed single-family development with high debt (2:1 value to lien or worse); No debt service reserve; Raw land in a remote location.

Such distinctions are important, since the nature of real estate and construction risk can vary widely among undeveloped districts. Special districts with debt rated below investment-grade display an even greater degree of unique variety than more highly rated debt. Nevertheless, certain commonly found situations would compare in terms of creditworthiness (see *Ranking Characteristics of Special Tax Districts* chart on page 81). Fundamentally, creditworthiness for special districts depends on prospects for strong real estate values, reasonable debt levels, and taxpayer diversity.

Legal covenants

Strong structural legal protections regarding taxpayer foreclosure, debt service coverage, or debt service reserves cannot, in and of themselves, raise a rating into the investment-grade category unless favorable real estate conditions exist. Legal covenants providing meaningful bondholder protection must lock in the economic benefits of a strong tax base against future issuer actions, such as additional debt dilution or poor tax collection procedures, but the tax base must exist first.

Thus, a Mello-Roos bond with a weak tax base will not necessarily be able to improve its bond rating with strong structural legal covenant protections, since there is little to protect. On the other hand, a Mello-Roos district with a strong tax base may be prevented from obtaining a higher bond rating by weak structural protections.

If development occurs, creditworthiness may improve dramatically in an undeveloped district. However, weak legal protections, written in at the time of bond sale, may limit upside rating potential even if the tax base develops as planned. Investors still need to examine legal covenants closely in almost all situations, even before development occurs.

In particular, a fully funded debt service reserve may buy an issuer some time during periods of heavy foreclosures, but cannot cover against ultimate losses. Other legal provisions of importance include:

- Maximum permitted tax rates;
- Additional bonds tests; and
- The timing of foreclosures and tax rate changes.

There are also key legal differences between unlimited tax special districts, Mello-Roos debt, and special assessment debt, although undeveloped districts share similar real estate development risk. Special district and Mello-Roos bonds usually have the flexibility to raise tax rates to cover a taxpayer foreclosure loss. This is a key strength of special district and Mello-Roos debt over special assess-

ment bonds. Special assessment bonds usually have just 1x coverage of annual debt service by yearly special assessments and lack any ability to raise tax rates. In such cases, the bond may be only as strong as the ability to receive ultimate repayment from the weakest property taxed.

Exceptions exist. Sometimes debt service reserve earnings can cover foreclosure losses of the top taxpayers if the top taxpayers are small, compared with the total tax base. Another exception occurs in Florida, where the state allows the special assessment tax rate to be raised in many cases, up to a limited amount. This feature makes many Florida special assessment bonds resemble California's Mello-Roos bonds—a positive feature. Some Florida special assessment bonds are rated in the 'A' rating category.

Land appraisals

Appraisals of vacant land by private consultants may be problematic. The difficulty is that they are based only on a value at a point in time, and built on a set of assumptions that developers will follow the expected use of the land. If plans do not materialize as anticipated, or new landowners change their expected use of the land, actual values for vacant land could change appreciably. For this reason, private appraisals of raw land can often be considered unreliable. Standard & Poor's looks at the reasonableness of appraisal assumptions and sometimes may discount appraisal conclusions. There are wide distinctions between different types of development districts, and investors more than ever need to distinguish the strong credits from the weak. In particular, investors may want to determine if legal features could preclude a bond from ever moving into the investment-grade categories. The accompanying table, while it does not cover every case, should provide helpful guidelines. Some positive factors, such as debt service coverage, can offset other negative factors, such as taxpayer concentration.

District Size

Standard & Poor's does not have a minimum size limit for an investment-grade rated special district; rather size impacts a special district in that a small size may increase taxpayer concentration. A large district concentrated in a few taxpayers may not be as creditworthy as a small district with little tax base concentration in the top taxpayer. A special district consisting only of a 500-unit single-family housing development, for example, may achieve an investment-grade category rating, depending on the particulars of local real estate conditions.